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San Diego, California; Water/Sewer

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Credit Profile		
San Diego certs of undivided int (payable from net sys revs of wtr util fd)		
<i>Unenhanced Rating</i>	AA-(SPUR)/Stable	Reinstated
San Diego Pub Facs Fincg Auth, California		
San Diego, California		
San Diego Pub Facs Fincg Auth (San Diego) sub wtr (MBIA)		
<i>Unenhanced Rating</i>	A+(SPUR)/Stable	Reinstated
Many issues are enhanced by bond insurance.		

Rationale

Standard & Poor's Ratings Services reinstated its 'AA-' underlying rating (SPUR), and stable outlook, on San Diego, Calif.'s senior-lien water revenue bonds and its 'A+' SPUR, and stable outlook, on the city's subordinate-lien water revenue bonds.

The ratings reflect the following credit strengths:

- Good historical and projected financial performance,
- Strong cash reserves bolstered by targeted cash reserve policies,
- Council-approved system rate increases through fiscal 2011, and
- A stable and diverse service area economy and customer base.

Offsetting credit concerns include the system's:

- Significant capital improvement plan (CIP) driven by regulatory concerns, with considerable financing plans over the next five years;
- Required annual approvals for customer water charge increases related to passed-through water purchase costs; and
- Senior-lien legal provisions that allow net system revenue calculations to include transfers from the rate stabilization fund and secondary purchase funds.

A senior-lien pledge of installment payments payable from the net revenues of the city's water system secures the series 1998 certificates of undivided interest and a subordinate-lien pledge secures the series 2002 bonds.

Covering 330 square miles with a population of 1.3 million, San Diego's water system provides retail water services to a stable customer base consisting of 271,000 primarily residential (91%) and commercial or industrial (6%) accounts. The water system is supplied primarily by raw water imported by the County Water Authority (CWA, 'AA+' underlying rating (SPUR), which accounts for more than 90% of the system's water supply. CWA, in turn, received 76% of its water from the Metropolitan Water District of Southern California (MWD, 'AAA' SPUR) in 2007.

Currently the water system has roughly \$745 million of outstanding revenue bonds, state revolving fund (SRF) loans, and private placement notes secured by senior and subordinate liens of the system's net revenue. Coverage of

senior debt service on the series 1998 certificates by net system revenue in fiscal 2006 was 2.9x. Total combined senior and subordinate debt service -- including the 2002 bonds, debt service on SRF loans, and interest on outstanding short-term notes--was 1.7x. Based on unaudited results for fiscal 2007, system officials estimate net system income -- including operating receipts, capacity charges, and interest earning revenue -- provided senior and combined debt service coverage of roughly 3.6x and 1.9x, respectively, due to recent increases in rates and pass-through charges for purchased water. Excluding capacity charges, estimated senior and combined debt service coverage (DSC) drops to 3.0x and 1.5x, respectively. Coverage of fixed water purchase charges and combined debt service, excluding capacity charges, totaled 1.4x in fiscal 2007, based on unaudited results.

System officials project net system revenues through fiscal 2012 to cover existing debt service, excluding note principal, by roughly 1.5x to 3.0x. Actual DSC is likely to be lower as the system issues additional debt in the near term. Fiscal 2009 projections account for a 15% reduction in revenue and offsetting costs associated with proposed water conservation measures in fiscal 2009. In fiscal 2010, currently scheduled senior debt service steps down significantly as the series 1998 bonds mature.

Liquidity at fiscal year-end 2006 was a strong \$155 million, equivalent to 235 days of operating expenses. Officials have identified reserve policies to maintain cash within the system, including a targeted 50- to 70-day operating reserve to be used for unplanned operating expenditures, a secondary purchase reserve funded at 6% of annual water purchase costs to offset potential disruptions in the water supply, a \$5.0 million emergency reserve for capital expenditures, and a \$20.5 million rate stabilization fund. The system also maintains restricted cash reserves for debt service requirements. System officials estimate that combined cash in the operation reserve, secondary fund, rate stabilization fund, and emergency reserve in fiscals 2006 and 2007 totaled \$50 million, or 76 and 71 days' cash, respectively.

The system's CIP for 2008 through 2012 totals about \$600 million, with about 85% of the capital project expenditures related to a California Department of Health (DPH) compliance order to fund pipe replacement, improve treated water storage, and treatment facility upgrades. The system has issued \$200 million in private placement notes in 2007 and 2008 and intends to use long-term debt to pay off notes and fund 80% of the CIP. In fiscals 2007 and 2008, water rates increased 6.0% and 6.5%; the city council has already approved 6.5% annual increases for fiscals 2009 and 2010 to fund identified capital projects through 2012. The city council also approved pass-through charges to cover increased purchased water costs in fiscal 2008 and will annually determine pass-through charges for future increases in purchased water costs.

A senior-lien pledge of the water system's net revenues secures the series 1998 certificates. The senior-lien legal provisions are somewhat permissive. The senior-lien 1.2x maximum annual debt service (MADS) rate covenant allows revenues to be adjusted to include transfers from the rate stabilization fund and secondary reserve, as well as capacity charges. The senior-lien legal provisions also require 1.2x MADS coverage using either historical revenues in 12 out of the past 18 months or future revenues adjusted for rate increases and estimated revenue from expected water system additions, improvements, and extensions.

A subordinate-lien pledge of the water system's net revenues secures the series 2002 bonds. The system also has an outstanding SRF loan and issued short-term notes in 2007 and 2008 secured by a subordinate lien on parity with the series 2002 bonds. The series 2002 legal provisions allow additional bonds if the system can demonstrate at least 1x senior and subordinate MADS coverage by net system revenues (net system revenues may be adjusted for rate increases or system improvements). Legal provisions for both the senior and subordinate liens include a fully funded

debt service reserve funded at the least of MADS, 10% of par, or 1.25x aggregate average annual debt service.

Outlook

The stable outlook reflects the expectation that pre-approved rate increases should help to maintain good debt service ratios in the next several years, despite the city's implementation of a large CIP associated with regulatory requirements. The outlook also reflects the expectation that pass-through charges for increased water purchase costs and future rate increases will be approved, as necessary, and the system will adhere to its cash reserve policies to maintain sufficient liquidity in the system. Should a failure to continue to meet the requirements of the compliance order result in significant deterioration of DSC or liquidity, we could lower the ratings.

Customer Profile

The water system services the city of San Diego and certain surrounding areas on a retail basis, which accounts for 94% of water sales. The remaining 6% of water revenue is derived from the delivery and treatment of water to wholesale customers: California-American Water Co. (3.5% of fiscal 2006 revenue); the city of Del Mar, Calif.; Santa Fe Irrigation District; and San Dieguito Irrigation District. The water system is also currently negotiating with Otay Water District and may fund facility improvements necessary to deliver treated water to the Otay Water District service area.

Of the system's 271,000 accounts, residential customers represent 62% of revenue, while commercial or industrial customers represent 32% of revenue; wholesale accounts represent 5% of revenue. As of fiscal year-end June 30, 2006, the 10 leading retail customers of the water system accounted for 12% of total water utility fund revenues; the city of San Diego (4.1% of water sales revenue) and the U.S. Navy (3.2%) were the two leading customers.

Operations

Current estimates indicate that the city's water supply is sufficient to meet its needs through 2030, although a federal ruling in 2007 caused the state's recent decision to limit pumping of water from the Sacramento Delta due to the endangerment of the Delta Smelt fish population. This should not present water supply problems in the short run due to MWD's large amount of banked water, although it could cause concern if dry conditions in northern California persist for extended periods of time, especially as the Colorado River basin continues to experience drought. MWD has initiated various conservation programs to reduce overall water consumption in southern California during the area's currently dry conditions. The city has also recently asked residents and businesses to adopt water conservation practices; however, in February 2008, the San Diego County Grand Jury -- a citizen group that evaluates city and county government procedures to determine whether they can be made more efficient -- filed a report with recommendations to the city council to further improve the city's water conservation measures. The city's long-range water resources plan seeks to identify future water resources to meet demand and diversify its water supply through the development of potential groundwater resources, the expansion of reclaimed water programs, and the pursuit of water transfers.

The city's water system consists of three treatment plants with a current total rated capacity of 296 million gallons per day (mgd). Average daily treatment flow for the combined water system was 202 mgd in fiscal 2006, with a peak of 286 mgd. The system also maintains nine raw water reservoirs with a total capacity of 415,936 acre-feet, or

135.5 billion gallons, which are connected to the treatment plants. The delivery and distribution system consists of more than 3,460 miles of pipeline and 49 pumping plants in more than 90 pressure zones.

Rates And Collections

As of July 1, 2007, rates were competitive, at roughly \$32 for a single-family home using 7,500 gallons per month (or \$48.24 per 1,400 cubic feet). The city council pre-approved rate increases for four consecutive years between fiscals 2007 and 2010 to address the system's CIP. The system will use the rate increases to fund identified projects through 2012; the pre-approved rate increases do not include additional pass-through rate increases for increased costs of purchased water from the CWA to water users. In January 2008, the council approved a 3% rate increase to cover 7% increases in water purchase costs in 2008, increasing the total water rate to \$33.40 per 7,500 gallons. MWD and CWA have proposed increases to water purchase costs for fiscal 2009 that system officials expect to pass on to customers in January 2009, although pass-through water charges are subject to council approval and Proposition 218 hearings. Together with the sewer rates, overall residential rates are somewhat above average for a regional system, at roughly \$75 per 7,500 gallons per month, but still a manageable 2% of the city's annual median household income.

Audit Restatements And Internal Controls

The fiscal 2003 audit included 19 restatements within the fiscal 2002 financial statements for the water utility fund, which resulted in a net \$96 million increase of water utility fund assets. The largest restatements in the water utility fund involved the inaccurate recording of capital assets. After the SEC and U.S. Attorney began investigations of the city's finances and disclosure practices in 2004, the city hired Kroll Inc., a risk-management consulting company, to conduct an independent investigation of the city's retirement system, sewer rates, and financial controls and make recommendations for reform. Kroll released its report in 2006 detailing 121 recommendations to strengthen the city's internal controls. The city has made progress toward improving internal controls and disclosure processes, implementing 92 of the 121 recommendations. However, the city acknowledges it still has to continue to bolster internal controls, particularly in the areas of financial reporting, information technology, and internal controls. City management expects the full implementation of new enterprise resource planning (ERP) software in January 2010 to help resolve internal control weaknesses and aid in the timely release of future financial reports. City officials expect the release of the fiscal 2007 audited financial statements in the next few months and the fiscal 2008 audit by the end of the year.

Regulatory Issues And Capital Improvement Plan

The San Diego water system is currently under a compliance order from the DPH to implement improvements to their water system in line with Environmental Protection Agency regulations. The system's CIP is driven primarily by improvements under this compliance order which requires the system to replace 10 miles of pipeline per year, expand water treatment capacity, and improve water treatment processes. Due to the system's limited access to the financial markets after the SEC and U.S. Attorney investigations, the system has been working to keep up with the capital needs of the system under the compliance order. The system issued \$200 million in privately placed short-term notes over the past couple years to continue funding of necessary capital improvements; the notes mature in 2009. The system intends to fund 80% of its CIP with debt. The failure to fund improvements and replace aging

pipelines according to schedule could result in penalties or the loss of state matching dollars.

Service Area Economy

San Diego's population, estimated at 1.32 million in fiscal 2007, has grown an average of roughly 1% per year since the 2000 U.S. Census. The economy consists of a mix of various high-tech clusters, including biotech and telecommunications, combined with a reliance on tourism and the military and defense industries. The city's economic base is also anchored by higher education and major scientific research institutions, including the University of California, San Diego, San Diego State University, Scripps Research Institute, the Salk Institute for Biological Studies, and the San Diego Supercomputer Center. On a per capita basis, market values are extremely strong, at roughly \$134,000, reflecting strong city wealth levels. Median household effective buying income is also strong, at 111% of the national average in 2007.

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